

## Message Text

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ACTION ARA-14

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-03  
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R 162149Z MAY 78  
FM AMEMBASSY BRASILIA  
TO SECSTATE WASHDC 7533  
INFO AMCONSUL RIO DE JANEIRO  
AMCONSUL SAO PAULO

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EO 11652: N/A  
TAGS: EGEN, BR  
SUBJ: ASSESSMENT OF BRAZILIAN ECONOMIC POLICY

REFS: A. BRASILIA 9998 (77), B. BRASILIA 541, C. BRASILIA 904,  
D. SAO PAULO 338, E. BRASILIA 923, F. RIO 739, BRASILIA 2137,  
H. BRASILIA 3058, I. BRASILIA 3440

1. SUMMARY. THIS MESSAGE, BASED ON CONTRIBUTIONS FROM EMBASSY  
AND CONGENS RIO AND SAO PAULO, DRAWS UPON PREVIOUS REPORTING  
TO PROVIDE A GENERAL ASSESSMENT OF THE PERCEPTIONS OF BRAZILIAN  
ECONOMIC DECISION MAKERS AND THE EXPECTED OPERATION  
OF BRAZILIAN ECONOMIC POLICY OVER THE NEXT YEAR. END SUMMARY.

2. IN SPITE OF SIGNIFICANT IMPROVEMENT IN THE BALANCE OF PAYMENTS  
AND SOME PROGRESS TOWARD REDUCING INFLATION IN 1977, BRAZIL'S  
ECONOMIC LEADERSHIP DURING THE YEAR GRADUALLY CHANGED ITS VIEWS  
ON THE COUNTRY'S MEDIUM-TERM ECONOMIC PROSPECTS. FACED WITH CONTINUED  
RAPID INCREASE IN THE EXTERNAL DEBT, CONSEQUENT DETERIORATION  
OF THE VARIOUS DEBT RATIOS, AND HIGH INFLATION, THIS LEADER-  
SHIP -- CONSISTING PRINCIPALLY OF THE PRESIDENT HIMSELF,  
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FINANCE MINISTER SIMONSEN, AND PLANNING CHIEF REIS VELLOSO -  
CONCLUDED THAT BRAZIL'S GROWTH WOULD HAVE TO BE SLOWED TO  
5-6 PERCENT NOT ONLY IN 1977 BUT FOR PERHAPS AN ADDITIONAL  
2-3 YEARS; I.E., UNTIL INFLATION IS FURTHER REDUCED AND BRAZIL  
CAN ACHIEVE A SUBSTANTIAL TRADE SURPLUS IN ORDER TO REDUCE ITS  
CURRENT ACCOUNT DEFECIT AND FOREIGN BORROWING TO SUSTAINABLE  
LEVELS.

3. OBJECTIVES OF THE PRESENT LEADERSHIP ARE:

(A) TO REDUCE INFLATION WHICH WAS 39 PERCENT IN 1977, TO THE LOW 30'S THIS YEAR IF POSSIBLE, AND TO THE MID TO LOW 20'S IN 1979.

(B) TO MAINTAIN THE TRADE ACCOUNT IN BALANCE THIS YEAR AND TO WORK TOWARD A SUBSTANTIAL SURPLUS IN THE TRADE ACCOUNT IN EXCESS OF \$1 BILLION NEXT YEAR THUS TO REDUCE THE RATE OF INCREASE IN INDEBTEDNESS IN RELATION TO EXPORTS; AND

(C) TO COMPLETE THE IMPORT SUBSTITUTION PROGRAM, THUS TO LOWER PERMANENTLY BRAZIL'S IMPORT COEFFICIENT AND LAY THE FOUNDATION FOR THE RESUMPTION OF MORE RAPID GROWTH.

4. KEY ELEMENTS OF THE PRESENT SITUATION:

(A) GROWTH THIS YEAR IS LIKELY TO REMAIN IN THE 5-6 PERCENT RANGE, IN ACCORDANCE WITH THE REVISED GROWTH STRATEGY; IN 1977, GROWTH WAS A MODEST 4.7 PERCENT.

(B) AGRICULTURE, WHICH SHOWED LARGE GAINS (9.6 PERCENT) IN 1977, IS ADVERSELY AFFECTED BY SEVERE DROUGHT IN THE KEY AGRICULTURAL AREAS OF PARANA, SAO PAULO, AND NORTHERN RIO GRANDE DO SUL. THE DROUGHT WILL NOT ONLY REDUCE INCOMES IN THESE AGRICULTURAL AREAS BUT ALSO THREATEN PUBLIC WORKS PROGRAMS BY REDUCING GOVERNMENT REVENUES.

(C) IT IS CLEAR THAT WITH THE EXPECTED POOR PERFORMANCE OF AGRICULTURE IN 1978, THE GOB IS AIMING AT MODERATE GROWTH IN THE MANUFACTURING SECTOR AND A CONTINUATION OF THE RAPID GROWTH LIMITED OFFICIAL USE

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OF MANUFACTURED EXPORTS TO ACHIEVE A BETTER ECONOMIC GROWTH RECORD THAN IN 1977 AND AVOIDANCE OF DETERIORATION IN THE TRADE ACCOUNT.

(D) THE OUTLOOK FOR EXPORTS THIS YEAR IS UNCERTAIN IN VIEW OF REDUCED CROPS AND LOWER PRICES. WHILE EXPORTS OF MANUFACTURED GOODS ARE EXPECTED TO RECORD A GOOD PERFORMANCE AGRICULTURAL EXPORTS MIGHT BE OFF BY AS MUCH AS \$1 BILLION OR MORE. THUS, BRAZIL CAN AT THE VERY BEST HOPE TO MAINTAIN A ROUGH BALANCE IN ITS TRADE ACCOUNT, WITH A MODERATE DEFICIT A FAR MORE LIKELY OUTCOME,

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DEPENDING ON CONDITIONS IN THE INTERNATIONAL COFFEE MARKET AND BRAZIL'S ABILITY TO MAINTAIN EARLY YEAR GROWTH RATE IN MANUFACTURED PRODUCTS. (AGRICULTURE MINISTER PAULINELLI, AS A RESULT OF A TRIP THROUGH THE DROUGHT-STRICKEN AREA, HAS FORECAST A DROP IN AGRICULTURAL EXPORTS OF \$1.5 BILLION; FINANCE MINISTER HOWEVER, PREFERS TO MAINTAIN FORECAST OF A \$1 BILLION DROP. REIS VELLOSO, WHILE CONCEDED A \$1.5 BILLION DROP IN AGRICULTURAL EXPORTS, HAS SAID HE EXPECTS THE TRADE ACCOUNT TO BE IN BALANCE AT THE \$11.5-\$12 BILLION LEVEL, THROUGH CUTS IN PUBLIC SECTOR IMPORTS.

(E) PRIVATE INVESTMENT ACTIVITY HAS BEEN RELATIVELY WEAK. TO STIMULATE THE ECONOMY, THE GOB THIS YEAR IS PERMITTING SOME INCREASE IN PUBLIC SECOTR INVESTMENT PROGRAMS AND HAS INCREASED THE BNDE'S LENDING LEVELS.

(F) SLOWER GROWTH IN 1977 IMPACTED ESPECIALLY ON THE DURABLE GOODS AND AUTOMOBILE SECTORS, CONCENTRATED IN THE SAO PAULO REGION. ON THE OTHER HAND, ACTIVITY IN BASIC AND CAPTIAL GOODS INDUSTRIES IN SAO PAULO AND OVERALL ACTIVITY IN REGIONS OF THE COUNTRY WHERE NEW INVESTMENT ACTIVITY IS CONCENTRATED, SUCH AS MINAS GERAIS AND BAHIA, HAVE BEEN HOLDING UP RELATIVELY WELL AND IN MANY CASES CONTINUED TO SHOW SUBSTANTIAL GAINS. ACTIVITY IN LIMITED OFFICIAL USE

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SAO PAULO HAS PICKED UP SOMEWHAT IN THE FIRST QUARTER OF 1978, AS A RESULT OF HIGHER AUTOMOBILE PRODUCTION AND RECOVERY IN THE CONSUMER DURABLES SECTOR. IT IS NOT CLEAR WHETHER THIS HIGHER LEVEL OF ACTIVITY IS PERMANENT, INASMUCH AS THE PICK-UP WAS ATTRIBUTABLE TO A SURGE IN DEMAND FOR CONSUMER DURABLES. THE GOVERNMENT, HOWEVER, CLEARLY HAS THE INTENTION TO STIMULATE MODERATE GROWTH IN INDUSTRIAL ACTIVITY TO COMPENSATE FOR THE ADVERSE TRAND IN THE AGRICULTURAL AND MINING SECTORS.

(G) IN SPITE OF THE LOWER RATE OF GROWTH, THERE IS NOT YET EVIDENCE OF SUBSTANTIAL INCREASE IN UNEMPLOYMENT. HOWEVER, DURING 1977 URBAN EMPLOYMENT DID NOT KEEP PACE WITH URBAN

POPULATION GROWTH THERE IS INCREASING CONCERN OVER A FUTURE  
UNEMPLOYMENT PROBLEM.

(H) INFLATION IS BEING REDUCED ONLY GRADUALLY, AT THE COST  
OF SUBSTANTIALLY REDUCED GROWTH, OWING TO STRUCTURAL PROBLEMS  
SUCH AS WIDESPREAD INDEXING AND IMPORT RESTRICTIONS. THE  
EFFECTS OF THE DROUGHT IMPEDE THE FIGHT AGAINST INFLATION AND  
MAKE IT DOUBTFUL WHETHER MUCH PROGRESS CAN, IN FACT, BE MADE  
IN THIS AREA THIS YEAR.

(I) AS IN 1977, BRAZILIAN MONETARY AUTHORITIES ARE HAVING  
DIFFICULTY IN MEETING MONETARY TARGETS. A LARGE INFLUX OF FOREIGN  
LOANS DURING FIRST QUARTER 1978 HAS ALREADY PUT MONETARY GROWTH  
OFF TARGET THIS YEAR AND OTHER FACTORS, SUCH AS THE IMPACT OF  
GOB FISCAL PROGRAMS MEANS THE PROVISIONAL TARGET OF ONLY  
25 PERCENT GROWTH IN THE MONEY SUPPLY WILL BE EXCEEDED (SEE  
REF A).

(J) BRAZIL'S TOTAL PUBLIC AND PRIVATE EXTERNAL DEBT IS LIKELY  
TO RISE TO AROUND \$35 BILLION BY END 1978. BECAUSE OF THE SLOW  
GROWTH IN EXPORTS, SOME DETERIORATION IN THE COUNTRY'S DEBT  
RATIO CAN BE EXPECTED. NONETHELESS, BRAZIL WILL HAVE NO DIFFICULTY  
IN OBTAINING NEW FINANCING, A MAJOR PORTION OF WHICH IS ALREADY  
ARRANGED, ON MORE FAVORABLE TERMS THAN LAST YEAR.

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5. FROM PRESENT PERSPECTIVE THE PAST YEAR APPEARS TO REPRESENT  
AN IMPORTANT TURNING POINT IN BRAZIL'S ECONOMIC POLICY FOLLOWED  
SINCE PETROLEUM CRISIS OF 1973 (REF B). THE PERCEPTION OF BRAZIL'S  
KEY ECONOMIC POLICY MAKERS -- PRESIDENT GEISEL HIMSELF, FINANCE  
MINISTER SIMONSEN, AND PLANNING CHIEF REIS VELLOSO AS TO  
BRAZIL'S NEAR/MEDIUM TERM PROSPECTS AND REQUIREMENTS APPEARS TO  
HAVE CHANGED IN IMPORTANT RESPECTS, AND LED TO THE EXTENSION  
TO PERHAPS 1980 OF THE MODIFIED GROWTH STRATEGY ADOPTED IN LATE  
1976. THE ESSENCE OF THE CHANGE IS SUMMED UP IN REIS VELLOSO'S  
FORMULATION THAT BRAZIL NEEDS TO FOLLOW A LOWER GROWTH  
PATH AND IN SIMONSEN'S CONCEPT THAT BRAZIL NEEDS TO REDUCE  
THE SHARE OF DOMESTIC CAPITAL FORMATION FINANCED BY FOREIGN  
SAVINGS (I.E., REDUCE THE DOMESTIC SAVINGS - INVESTMENT GAP),

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THEREBY REDUCING THE GROWTH OF EXTERNAL INDEBTEDNESS IN RELATION TO THAT OF EXPORTS. THIS STRATEGY ASSUMES THAT THE DOMESTIC SAVINGS RATE CANNOT BE SHARPLY INCREASED AND THAT, THE EXCELLENT EXPORT PERFORMANCE IN 1977 NOTWITHSTANDING, THE PROSPECTS FOR THE RESUMPTION OF A HIGHER RATE OF GROWTH IN EXPORTS ON A SUSTAINED BASIS REMAIN UNCERTAIN, GIVEN THE MODEST GROWTH OF BRAZIL'S PRINCIPAL MARKETS. THE ADJUSTMENT THUS WOULD HAVE TO TAKE, FOR AN UNDEFINED PERIOD, THE FORM OF LOWER GROWTH. QUITE ASIDE FROM THE EFFECT OF CONTINUING INFLATIONARY PRESSURES ON INTERNATIONAL CONFIDENCE, THIS SHIFT IN POLICY ALSO RESTS ON THE FUNDAMENTAL PERCEPTION THAT, WHILE BRAZIL'S CREDIT STANDING REMAINS VERY HIGH, EXTERNAL INDEBTEDNESS HAD BEEN INCREASING AT AN UNSUSTAINABLE RATE IN RELATION TO EXPORTS THUS THREATENING THE COUNTRY'S CREDITWORTHINESS IN THE MEDIUM AND LONGER TERM.

6. WHILE THE FINANCIAL AUTHORITIES HAD BEEN CONCERNED ABOUT BRAZIL'S EXTERNAL DEBT RATIOS FOR SOME TIME (BEGINNING AT LEAST IN 1975)N THE EVENTS PRECIPITATING THE CHANGE IN POLICY WERE THE UNEXPECTED ECONOMIC RESULTS OF 1976--46 PERCENT INFLATION ACCOMPANYING 9.2 PERCENT REAL GROWTH. MEETING IN LATE 1976 WITH SIMONSEN AND REIS VELLOSO, PRESIDENT GEISEL AGREED TO LIMITED OFFICIAL USE

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THE NEW STRATEGY, WHICH SINCE THEN HAS BECOME STANDARD VOCABULARY IN THE EXPOSITION OF THE GOB'S ECONOMIC STRATEGY. IN ESSENCE, THE GOB GAVE UP THE HOPE THAT BRAZIL WAS DIFFERENT, I.E., THAT BRAZIL COULD LEAP OVER THE WORLD ECONOMIC RECESSION THROUGH EXTERNAL BORROWING, AND MAINTAIN HIGH AVERAGE GROWTH RATES AT OR ABOVE BRAZIL'S 7 PERCENT LONG-TERM AVERAGE WHILE ALSO CARRYING FORWARD A LARGE IMPORT SUBSTITUTION PROGRAM IN BASIC INDUSTRIES DESIGNED TO REDUCE IMPORTS LARGELY TO CAPITAL GOODS AND PETROLEUM BY THE BEGINNING OF THE 1980'S. THE RATE OF INCREASE IN EXTERNAL INDEBTEDNESS, THE RISING INFLATIONARY PRESSURES, AND THE LONGER THAN EXPECTED DURATION OF DEPRESSED WORLD ECONOMIC GROWTH, COMPELLED A RECONSIDERATION OF THE POLICY.

THE STRATEGY OF IMPORT SUBSTITUTION REMAINS IN PLACE - A PROGRAM WHICH HAS MADE SUBSTANTIAL PROGRESS WILL FOR THE MOST PART BE COMPLETED BY THE EARLY 80'S -- AS DOES THE HIGHLY SUCCESSFUL OIL CONSERVATION PROGRAM, WHICH AS SUCCEEDED IN APPROXIMATELY STABILIZING IMPORTS--BUT OVERALL GROWTH HAS BEEN REDUCED. JUDGING FROM VARIOUS STATEMENTS BY SIMONSEN, PUBLIC AND OFF THE RECORD, THE OBJECTIVE OF THE STRATEGY IS TO MAINTAIN REAL GROWTH IN THE 5-6 PERCENT RANGE AND LOWER GROSS CAPITAL FORMATION SUFFICIENTLY TO REDUCE THE SHARE OF EXTERNAL SAVINGS FROM 17 PERCENT OF CAPITAL FORMATION IN 1976 TO AN ESTIMATED 10 PERCENT IN 1977 AND PERHAPS TO 5 PERCENT BY 1980. SIMONSEN, VELLOSO, AND OTHERS ARE VAGUE HOW LONG THE NEW POLICY WILL BE MAINTAINED BUT IMPLY THAT IT SHOULD BE SUSTAINED FOR AT LEAST THIS YEAR AND PERHAPS THE NEXT TO BRING INFLATION FROM ITS CURRENT LEVEL IN THE HIGH 30'S INTO THE MID-TO-LOW 20'S RANGE. THE RATIONALE OF THE POLICY, ON THE OTHER HAND, WOULD REQUIRE THAT IT BE MAINTAINED UNTIL BRAZIL HAS ACHIEVED A SIGNIFICANT REDUCTION IN THE MARGINAL PROPENSITY TO IMPORT AS A NECESSARY CONDITION FOR A SUSTAINABLE LARGE TRADE SURPLUS (I.E. \$1 BILLION OR MORE) AND REDUCTION IN THE CURRENT ACCOUNT DEFICIT. RECENT STUDIES ON THE MEDIUM-TERM OUTLOOK FOR THE LIMITED OFFICIAL USE

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BRAZILIAN ECONOMY -- SUCH AS THOSE BY CHASE-MANHATTAN AND THE WORLD BANK -- PROJECT A MODERATE RATE OF GROWTH FOR THE REMAINDER OF THE DECADE ON THIS BASIS (REF I)M

7. THE LEGACY OF THE POLICY FOLLOWED BETWEEN 1974-76 IS A SUBSTANTIAL SERVICES DEFICIT ( DUE TO THE INTEREST BURDEN ASSOCIATED WITH THE INCREASE IN EXTERNAL DEBT, WHICH ROSE FROM \$12 BILLION IN 73 TO \$31 BILLION AT END 1977) REF G. ON THE OTHER HAND, THE (INCOMPLETE) IMPORT SUBSTITUTION PROGRAM IS ESTIMATE TO YIELD SOME \$2.0 BILLION IN FOREIGN EXCHANGE SAVINGS PER YEAR BY 1981 OR ABOUT 10 PERCENT OF

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EXPECTED EXPORTS. THE IMPORT SUBSTITUTION PROGRAM, THE HEAVY RELIANCE ON IMPORT RESTRICTIONS, THE SURGE OF INFLATION IN 1976 AND -- MORE RECENTLY -- THE DECELERATION OF THE ECONOMY HAVE PRODUCED CONTROVERSY OVER THE GOB'S ECONOMIC POLICY. ORTHODOX ECONOMISTS BELIEVE THAT THE SEVERE IMPORT RESTRICTIONS, OVER-VALUATION OF THE CRUZEIRO, AND ADMINISTRATEVELY-FORCED INVESTMENT PROGRAMS IN BASIC INDUSTRIES, TOGETHER WITH ADMINISTERED PRICES AND SUBSIDIZED CREDIT MECHANISMS, HAVE PRODUCED PROGRESSIVELY GREATER DISTORTIONS AND INEFFICIENCIES, INCLUDING A REDUCED GROWTH IN BRAZILIAN EXPORTS. THE LEADING ROLE PERFORMED BY THE LARGE, PUBLICLY-OWNED COMPANIES IN THE IMPORT SUBSTITUTION EFFORT HAS INTENSIFIED THE CONTROVERSY OVER QUOTE ESTATIZACAO END QUOTE, THE GROWING ROLE OF THE STATE IN THE ECONOMY. THE DECELERATION OF THE ECONOMY AT A TIME WHEN CERTAIN BRAZILIAN PRIVATELY-OWNED COMPANIES SUCH AS IN THE CAPTIAL GOODS INDUSTRY ARE COMPLETING SUBSTANTIAL INDUSTRIAL EXPANSION PRGRAMS HAS RESULTED IN CONSIDERABLE PRESSURES ON THE GOVERNMENT TO SHIELD NATIONAL FIRMS AGAINST THE CIMPETITION OF MULTINATIONAL CORPORATIONS OPERATING WITHIN BRAZIL, SUCH AS THROUGH RESTRICTION ON NEW FOREIGN INVESTMENT AND RESERVED MARKETS FOR LIMITED OFFICIAL USE

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NATIONAL FORMS AS WELL AS INCREASED PREFERENCES ON CONTRACTS OPEN TO INTERNATIONAL BIDDINGS. THE GOVERNMENT, HOWEVER, WHILE MAKING MODEST ADJUSTMENTS -- SUCH AS GREATER SELECTIVITY IN THE GRANTING OF INVESTMENT INCENTIVES FOR NEW FOREIGN INVESTMENTS, AND GREATER ADMINISTRATIVE PRESSURE ON FOREIGN OWNED COMPANIES TO NATIONALIZE THEIR PRODUCTION AND ENLARGE THEIR EXPORTS -- HAS BEEN RESISTING FURTHER RESTRICTIONS ON FOREIGN CAPITAL (REF E). MONETARY, FISCAL AND INDUSTRIAL POLICIES FOLLOWED IN 1978 THUS WILL BE ESENTIALLY A CONTINUATION OF THOSE IN FORCE IN 1977 REF C. ATTEMPTS WILL BE MADE TO MORE CLOSELY CONTROL MONEY SUPPLY GROWTH WHILE A MODEST STIMULUS WILL BE ALLOWED FOR INVESTMENT SPENDINGTHROUGH A REAL INCREASE IN THE PUBLIC SECTION INVESTMENT PROGRAM (PRICIPALLY IN IMPORT SUBSTITUTION) AND A RISE IN THE BUDGET OF THE BNDE (THE NATIONAL DEVELOPMENT BANK) WHICH, WITH ANNUAL

LENDING OF SOME \$4 BILLION, REPRESENTS THE SINGLE MOST IMPORTS  
SOURCE OF INTERNAL FINANCING FOR PRIVATE AND PUBLIC SECTOR  
INVESTMENT.  
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